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O Consumer, Consumer! Where the Heck Art Thou, Consumer?

Our apologies to The Bard, but economists are starting to wonder. For 40 years leading up to the Great Recession, U.S. consumer spending was the world's economic lynchpin. It still accounts for nearly 70% of our GDP and 15% of global output. But since the mid-2009 trough, it has grown at less than half the rate that prevailed over the prior 15 years.

Last year's plunge in gas prices looked like it could add an annualized $180 billion to households' discretionary income. Indications are that a lot of those savings are being banked or used to pay down debt. The savings rate has rebounded from its historic lows of a decade ago. Wage growth has been tepid until quite recently, and part-time employment remains high.

Prolonged low interest rates have been a boon to those who were solvent enough to refinance. But the *Bank Credit Analyst* points out that household debt at 1.1 times income is still pretty high, although down from its peak of 1.3 in 2007. Since the recession, income growth and wealth expansion have tended to favor upper-income households with a lower and slower propensity to spend those gains.

Periods of lukewarm U.S. consumption often prompt the question of when other regions might pick up the slack. But there's no clear heir to the consumption crown. Europe is looking a little better with large dollops of monetary stimulus and a broad benefit from lower oil prices. China has the numbers and rising prosperity but also big transition challenges. Big oil *exporting* nations aren't feeling very flush. And much of the rest of the developing world still looks for reacceleration in the U.S. and/or China.

In other words, it's back on *us*, a rather familiar story. ■

Taking Turns

It's no secret that U.S. stocks have been *the* major asset category to have and hold since the 2008 financial crisis. But there have been other periods when stocks of companies *outside* the U.S. took the honors. The accompanying table shows how the trophy has changed hands over the past 44 years. Of special note is the big edge in the 1980s for the broad mix of foreign stocks, followed by the super bull run for U.S. equities from 1989 through 2000. Based on all this history, it seems obvious that the *next* big move will favor ...? ■

U.S. vs. Foreign Stocks *

From	To	Outperformer	By**
04/30/1971	03/30/1973	MSCI EAFE	62%
03/30/1973	10/31/1976	S & P 500	31%
10/31/1976	10/31/1980	MSCI EAFE	90%
10/31/1980	10/31/1982	S & P 500	34%
10/31/1982	02/28/1989	MSCI EAFE	409%
02/28/1989	08/31/2000	S & P 500	491%
08/31/2000	11/30/2007	MSCI EAFE	61%
11/30/2007	10/31/2014	S & P 500	58%
10/31/2014	06/04/2015	MSCI EAFE	1%

* U.S. Stocks: Standard & Poor's 500 Index
Foreign Stocks: MSCI Europe-Australia-Far East
** Difference in cumulative ending values
Source: Morgan Stanley, Bloomberg

China's Great Wall, of Worry

A year ago we walked through the concerns surrounding the apparent slowdown in China's growth rate and its efforts to better balance its economy between investment and consumption. For the year ended June 4, 2015, the average China Region mutual fund gained 26.5% in U.S. dollar terms. On might wonder what all the worrying was about?

Yet international investors have remained pretty skeptical even as the key index of shares available to domestic Chinese investors soared skyward in recent months. Starting in April, China eased restrictions on its citizens investing on the Hong Kong exchange, prompting a wave of mainland money into shares listed there. Still, equity valuations look modest compared to U.S. and other developed equity markets.

China has been a growth juggernaut, but it's still a developing nation with lots of debt and economic imbalances. The government is fighting a growth slowdown by loosening liquidity and credit provisions. Domestically, real estate is in considerable oversupply. Globally, China's sustained, historic surge of production continues to weigh on a host of sectors.

Last year China exported more steel than the combined output of the U.S., India and South Korea, the world's third, fourth, and fifth biggest producers. In 2013 Chinese officials identified 19 areas of significant overproduction including cement, aluminum, copper, chemical fiber, and paper. Those disinflationary winds blow around the world, helping to spur counter measures by U.S., European, and Japanese central bankers intent on heading off actual *deflation*.

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The Long Game: Are We Heading for a Lower Return World?

It's widely assumed that interest rates will soon rebound prompting a realignment of investment valuations and allocation strategies. Then again, that's been a widely held assumption for several years now.

Many investors would relish higher yields on CDs, money market funds, and investment grade bonds which traditionally set a base of real returns and forced riskier assets to offer a genuine prospect of even higher returns. That concept of a "risk premium" is a central tenet of capital asset pricing theories.

But what if rates stay quite low for another several years, reflecting a sustained excess of global savings and relatively tepid demand for credit? Do other investment assets, especially stocks, continue the strong performance of the past six years, or does the whole hierarchy of returns compress downward?

Implications for retirement planning are not trivial. Many projections to determine sustainable withdrawals from a diversified allocation are built on historical returns for various asset classes over the past 30 to 40 years. If the whole structure of mainstream investment returns compresses, the challenge of income sustainability becomes even more acute. Likewise for corporate and public pension plans whose promises of future benefits and funding requirements have largely been predicated on similar historically based assumptions.

Past periods of ultra-low real bond yields – the Great Depression, the World Wars, and the late 1970s – featured flight-to-safety investing with quality bonds heavily favored over stocks. Market price-to-earnings ratios (P/Es) fell below 10 in each of those periods, which were great times to build equity exposure if one had the nerve. Periods that began with P/Es as high as they are today typically have produced more lackluster multi-year returns.

An optimist can hope that corporate earnings rise at a good clip and interest rates remain subdued. A *realistic* optimist will hedge the potential for modest returns by boosting savings, controlling volatility through diversification, mixing bond maturities, taking advantage of tax-deferral, and strategizing to maximize Social Security benefits. All these can boost the likelihood of reaching long-term goals whatever the markets deliver.

For those entering or nearing retirement, the strong recovery by equity markets since the financial crisis has been a very welcome lifeboat. But there's still a long game to be played, and most studies of portfolio sustainability for a 30-year stretch show that performance during the first 10 years is a bigger factor than returns over the subsequent 20 years. That's a little food for thought before casting one's fate entirely to the market winds and assuming that those historical averages will prevail. ■

Investment Performance Review	**TOTAL RETURN *** **(dividends and capital gains reinvested)**			
Selected Mutual Fund Categories *	**--- Annualized through June 5, 2015 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	8.2 %	19.3 %	15.5%	7.4 %
Mid-cap Stocks (Blend)	7.7	20.1	15.7	8.4
Small-cap Stocks (Blend) †	6.9	19.3	15.3	8.3
Foreign Stocks (Large Blend) †	− 1.5	14.1	9.4	5.5
Diversified Emerging Markets †	− 4.6	6.0	3.9	7.5
Specialty Natural Resources	−16.9	3.3	4.3	5.3
Specialty Real Estate	5.3	11.3	14.2	6.9
Moderate Allocation	3.9	11.8	10.3	6.1
Long-term Bond	4.2	3.5	7.1	6.0
World Bond †	− 4.5	1.0	3.1	3.8
High-Yield Taxable Bond †	0.3	7.3	8.0	6.7
Long-term Municipal Bond	3.3	3.1	4.6	4.0

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

Income Now or Later? It Makes a Difference.

Speaking of playing the long game, Lord Abbett Management passes along this striking statistic. A $10,000 investment in the Standard & Poor's 500 Index in 1976 would have produced $4,452 in dividends in 2014. That assumes the investor had taken each year's dividends in cash along the way. By comparison, $10,000 invested in the Barclays U.S. Aggregate Bond Index in 1976, with interest drawn each year, would have yielded just $253 in 2014.

At the outset bonds looked like the better income play, producing $745 of interest in 1976 versus the S&P 500's dividend output of just $461. In fact, it was more than a decade before the yearly flow of dividends from the S&P pushed ahead of the interest income from the bonds of the Barclay's Agg.

These days, investors can look to much broader horizons than the S&P 500 for their equity dividend plays, but patience is paramount. And the next four decades are sure to be different from the past four in ways no one can really predict. It is a long game indeed. ■

Having a Target Seems to Help

What if Congress passed a law to help investors, and it actually did? About a decade ago these pages covered a pressing problem with *participant-directed* 401(k) retirement plans. A lot of those participants weren't showing much interest in self-directing their investments. At the same time, employers and plan trustees didn't want the liability of automatically steering those accounts into anything but the most conservative alternative, often a money market fund.

Letting retirement savings idle away the decades at short-term interest rates seemed a dubious strategy. Enter the Pension Protection Act of 2006. One provision of that huge legislation laid out guidelines for something called a Qualified Default Investment Alternative (QDIA). Plans could automatically direct participant contributions into investments meeting those guidelines and be substantially insulated from liability.

Investment companies responded with a proliferation of target-date retirement funds, the most familiar type of QDIA. As these pages have previously discussed, target-date funds are broadly diversified allocations designed to gradually shift their holdings as the targeted date draws nearer. Such funds now hold more than $755 billion in assets, up ten-fold in less than a decade.

Of course, popularity is not always predictive of great investment results, and investors are notoriously poor timers. Over the years a host of studies have indicated that the actual returns experienced by mutual fund investors typically fall short of the performance of the funds they hold. But the popularity of target-date funds is not a case of chasing hot market sectors or stocks.

Mutual fund researcher Morningstar studied investor experience across the dozen fund companies that had target-date offerings for the full decade ended December 31, 2014. Morningstar found that, on average, those investors experienced somewhat *better* returns than the funds themselves. On an asset-weighted basis, their average annualized return was pegged at 6.13% compared to 5.03% for the funds. That advantage appeared *not* to be a fluke, as it appeared in eight of the 12 fund companies studied.

Retirement plan trustees and participants will want to understand and monitor the target-date funds available to them, their ongoing expenses, and the manager's approach to modifying allocations along that specified glide path to retirement. That said, the primary value may be the target-date concept's reinforcement of basic precepts of retirement investing such as:

- Focusing on long-term objectives rather than short-term volatility and performance;
- Maintaining broad diversification through multiple market cycles;
- Saving regularly and persistently.

So far, targets seem to help. ■

Watch for Budget Battles to Resume

Remember the great kerfuffle over the "fiscal cliff" a few years back? It's been pretty quiet on the federal budget front since then, partly due to generally favorable trends. From 2011 to 2014 federal red ink shrank from $1.37 trillion to $513 billion. That still may sound like a big gap, but it's just 3% of U.S. gross domestic product, near the average deficit of the past 45 years.

The pace of improvement is slowing. In the first seven months of fiscal 2015 the deficit was $22 billion less than the year-earlier period. Revenues were up 9%, but outlays rose 6.5%, wholly attributable to Social Security and Medicare which may be entering a multi-year surge.

Defense spending has been flat to down, but geopolitical challenges are adding pressures on that front. Interest on the federal debt also has been flat, but the debt outstanding now tops $12 trillion. Interest expense could be a bigger factor if rates really do rise sustainably.

High profile budget skirmishes are looming, as four major forcing events converge around September 30th. The debt ceiling will need to be raised this fall, and spending authority must be established for fiscal 2016 which starts October 1st. Also percolating are partisan differences over an array of tax extenders and a big highway funding bill.

Hardly anybody is talking about this right now, but markets probably won't like it when budget brinksmanship is again hogging the headlines. Last time around it created a little *buying* opportunity. ■

Higher Income Can Raise Your Medicare Premiums, with a Time Lag

Most retirees know that rising income raises the amount of one's Social Security benefits counted as taxable income, up to 85% of one's benefits. But at even higher incomes, Uncle Sam takes another bite from Social Security.

Retirees with modified adjusted gross income (MAGI) over $85,000 ($170,000 if married filing jointly) are subject to increased Medicare Part B premiums. Since those premiums are deducted from Social Security benefits, that's where the adjustment is felt. It's based on the most recently filed tax return, so a 2014 return showing excess MAGI will affect the taxpayer's Social Security benefits during 2016.

MAGI includes Adjusted Gross Income *plus* any tax-exempt municipal bond interest. This is also the figure that determines how much of a retiree's Social Security benefits are taxable. So for many retirees, municipal bonds are *not* exactly tax-exempt. The sale of a home, business, or appreciated securities

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China's Great Wall ...

Newton taught us that for every action there's an equal and opposite reaction. In the marvelous maze of a global economy, the myriad reactions to any targeted action will hold many surprises. The International Monetary Fund recently estimated that China is now the world's largest economy. There may be some debate as to how that's measured, but not much doubt about the impact of its dynamic economic transition. ■

Making Every Second Count

Every four years we get an extra day in February. Leap Day was introduced more than 2,000 years ago in the transition from the Roman to the Julian calendar, and it has long been associated with quirky traditions such as women proposing to men. The rest of the time they typically display better judgment.

This June 30th we get an extra *second* to correct for a slight mismatch between our best clocks and the Earth's rotation. Notwithstanding humankind's prodigious technological advances, the Earth still takes its sweet time, and we simply have to adjust.

A few market worrywarts have voiced concern about potential disruption to computerized trading programs. But the masters of those algorithms should be able to devise a work-around so that the rest of us can just sit back and relish the extra time. After all, what is so rare as a *second* in June? ■

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Income Boost ...

also can easily result in smaller Social Security checks a couple years later.

Most retirees pay $104.90 per month for Medicare Part B which covers doctor visits and outpatient services. For those whose MAGI exceeds the threshold noted above, there are five levels of premium *surcharge* ranging from $42 to $230.80 monthly. Medicare Part D drug plan premiums also are subject to these income-based surcharges ranging from an extra $12.30 to $70.80 per month. All of the above figures are per person, so the impact on a retired couple can really add up.

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One may qualify for a premium adjustment if the following year's income dropped due to a "life changing event" such as retirement, marriage, divorce, death of a spouse, or the disposition of an income producing property that was beyond the taxpayer's control. The voluntary sale of a property does *not* qualify.

The income brackets that determine Medicare premium surcharges are not adjusted for inflation, so more retirees may find themselves getting clipped for higher premiums year by year. Social Security operates on a sliding scale in several ways. In other words, Uncle giveth, and Uncle taketh away. ■